

SUBCOMMITTEE NO. 4

Agenda

Mike Machado, Chair
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Room 113

Consultant: Dave O'Toole

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BUDGET ITEMS PROPOSED FOR CONSENT / VOTE ONLY

0850	California State Lottery Commission
8640	Political Reform Act
8910	Office of Administrative Law
CS 11.00	Information Technology Reporting Requirements
CS 11.10	Reporting of Statewide Software License Agreements

VOTE:

DISCUSSION ITEMS

0840 State Controller

The State Controller is the Chief Financial Officer of the state. The primary functions of the State Controller's Office (SCO) are to provide sound fiscal control over both receipts and disbursements of public funds; to report periodically on the financial operations and condition of both state and local government; to make certain that money due the state is collected through fair, equitable, and effective tax administration; to provide fiscal guidance to local governments; to serve as a member of numerous policy-making state boards and commissions; and to administer the Unclaimed Property and Property Tax Postponement Programs. The Governor's budget funds 1,142.3 positions (including 54.7 new positions) and \$27.8 million in expenditures.

VOTE-ONLY ISSUES

A. Finance Letters: Generally Accepted Accounting Principles Compliance Workload

The State Controller's Officer requests one permanent position and \$87,000 (various funds) to accommodate increased workload associated with the preparation of annual financial reports. The growth of new reporting statements issued by the Government Accounting Standards Board (GASB) relating to Generally Accepted Accounting Principles (GAAP) has caused the workload to increase significantly over the last decade. This workload has been performed by utilizing overtime to meet reporting deadlines, a practice the SCO believes has become counterproductive.

B. Budget Bill Language on Calculating the State's Liability for Post-Employment Benefits

Both the GAAP Compliance Finance Letter described above and the "Other Post Employment Benefits Reporting" BCP approved at the March 23rd hearing (which directs the SCO to compile an estimate of the state's liability for future post-employment benefits of current state workers and retirees, other than retirement benefits themselves) are important steps in better quantifying public employee pension costs and will enable the Legislature to better understand the magnitude of the state's unfunded liabilities.

The Controller's estimate of liability for retiree health benefits will require the use of the same types of actuarial methodologies and assumptions used by CalPERS to estimate retirement benefit liabilities (employee age distribution and year of anticipated retirement, for example). For consistency, these methodologies and assumptions generally should be the same, except where there is a specific reason to differ (more recent information, for example).

Because the state now funds only the current cost of retiree health benefits, GASB 45 requires the use of a short-term interest rate (such as the Pooled Money Investment Account—PMIA-earnings rate, or about 4% now) to "discount" future costs. If, on the other hand, the state were fully funding these liabilities (similar to retirement contributions), future costs could be discounted assuming at the earnings rate of a long-

term investment fund (such as the CalPERS rate of return of about 8 percent). The present value of the state's liability, using the higher investment discount rate, will be substantially lower than the liability calculated using the lower short-term rate. Accordingly, it would be useful for the Legislature and the Administration to have a second estimate calculated using the long-term investment rate in order to evaluate the potential costs and benefits of moving toward pre-funding retiree health benefits (as recommended by the LAO).

Staff suggests adding the following Budget Bill Language in Item 0840-001-0001 to address the issue:

The Controller's estimate of the state's liability for post-employment benefits prepared to comply with Governmental Accounting Standards Board (GASB) Statement 45 shall include, in addition to all other items required under the accounting statement: (a) an identification and explanation of any significant differences in actuarial assumptions or methodology from any relevant similar types of assumptions or methodology used by the California Public Employees' Retirement System to estimate state pension obligations, and (b) alternative calculations of the state's liability for post-employment benefits using different long-term rates of investment return consistent with a hypothetical assumption that the state will begin to deposit 100 percent or a lesser percent, respectively, of its annual required contribution under GASB Statement 45 to a retiree health and dental benefit trust fund beginning in 2007-08. This provision shall create no obligation of the state to change the practice of funding health and dental benefits for annuitants currently required under state law.

NOTE: This issue conforms with action taken by Assembly Budget Subcommittee #4.

C. Notice Backlog for Security-Related Accounts

The State Controller's Office requests \$620,000 General Fund and 7.5 positions (two-year limited-term) in 2006-07 and \$538,000 in 2007-08, for the purpose of eliminating an anticipated backlog of notices to owners of unclaimed securities (stocks, bonds, etc.). Code of Civil Procedure 1531(d) requires notices related to security claims be sent to owners within 180 days of receiving the property.

D. Replacement of Unclaimed Property System

The State Controller's Office requests \$3.393 million (\$2.109 million General Fund) and five two-year limited-term positions to replace the existing unclaimed property system. General Fund expenditures would be \$1.573 million in 2006-07 and \$536,000 in 2007-08. Cost savings will be approximately \$440,000 in 2007-08 and \$1 million ongoing in the out years. The current system is more than 20 years old and requires frequent modification to be able to accommodate modern data formats and regulatory changes. A Bureau of State Audits audit, from 2003, identified several of the deficiencies this new system will correct.

VOTE on Vote-Only Issues A through D:

DISCUSSION ISSUES

1. Bank Reconciliation System Project. The SCO requests \$710,000 (\$308,000 General Fund) to replace the State Controller's existing bank reconciliation system. This system tracks and issues bank warrants for the state, interacting with the State Treasurer, Department of Finance, Department of Motor Vehicles, CalSTRS, CalPERS, and the Franchise Tax Board. The SCO asserts that the technology of the current system is obsolete and technicians to maintain the system increasingly scarce. The proposed solution will use the services of a data conversion company to convert the existing database into a more modern and functional format.

Staff Comment: In the March 23, 2006, hearing, the Subcommittee expressed concern that the SCO had adopted a piecemeal approach to Information Technology (IT) projects and had no discernable plan to replace their antiquated IT systems. The SCO has reported that they have over 70 IT systems needing replacement (some portion of those will be rolled into other projects) and that the BankRec system is their next top priority.

The Subcommittee held this issue open and requested the SCO report to the Legislature on:

1. All IT projects needing replacement, project timelines, anticipated cost, and other information necessary to provide a comprehensive legacy systems replacement plan.
2. The steps the SCO intends to take to inform stakeholders of IT replacement plans.

In response to the Subcommittee request, the department has provided information describing their planned IT procurements over the next few years and the overriding guidance they use when determining priorities.

The SCO had previously stated that they are currently operating under the recommendations outlined in the 2002 IT infrastructure study by Gartner Consulting. That report provided a five to seven year plan for the SCO to use in modernizing the SCO's technology infrastructure. The central recommendation was that SCO should "incrementally modernize its existing systems and then exploit that modernization for direct business gain." The Gartner report did not provide a priority listing for the replacement of specific IT systems.

The SCO's response identifies the current and planned IT replacements. The currently under development or proposed projects are:

- the Human Resources Management System (underway);
- Unclaimed Property System replacement (proposed below);
- BankRec System;
- Local Government E-Claims System (underway);
- Electronic Fiscal Input Transaction System (underway);
- Apportionment Payment System (underway);
- In-Home Supportive Services System (separately proposed); and
- the Local Government Reporting System Upgrade (underway).

There are several planned tax system replacements, including the Tax Collection Refund, Gas Tax Refund, Property Tax Postponement, and Estate Tax Systems replacements, which will update the technology used on these systems with .net technology.

A much larger and more complex IT replacement will be that of the state's fiscal system. Like the Human Resources Management System, the fiscal system replacement project will have broad implications and impacts, replacing roughly 21 of the SCO's 70 legacy systems. This replacement will use an enterprise-wide approach enabled by current technology and will be inconsistent with, if not conform to, the Gartner study.

The SCO's overall IT replacement plan is based in part on the Gartner study, but also delegates IT project initiatives to program divisions, with cost always a primary driver. While recognizing the primacy of cost as an IT planning guide, the Subcommittee should continue to review long term IT replacement plans—particularly those of the legacy systems—when new IT proposals are presented.

Furthermore, as stated on the March 23, 2006, agenda, the SCO should make these priorities public and well known to all current stakeholders. The problem with not making IT priorities public is evidenced with the delayed implementation of the Human Resources Management System (HRMS) project. The uncertainty over when that system would be replaced led many departments to implement their own systems, creating a dissimilar patchwork of human resource tracking that must now be replaced. With a public plan and timelines, state and local agencies will be better able to prioritize their own IT procurements.

Staff Recommendation: APPROVE the BankRec BCP and request the SCO explain its processes for informing state and local stakeholders of its plans and timelines for IT replacements.

VOTE:

2. Unclaimed Property Audit of Holders

The State Controller's Office requests \$1.441 million and 15 positions for two-years to conduct field examinations of various California holders of unclaimed property. These examinations will include banks, hospitals, major financial institutions, and multinational companies. Audits involve mining data and contacting the institutions to determine if escheatment has occurred. The SCO estimates unclaimed property receipts of \$7.5 million in 2006-07 and \$15.0 million in 2007-08 and beyond.

Staff Comment: Private entities are required by law to escheat their client's private property to the state after a set period of time. When this does not occur, these entities unfairly benefit from the interest value of the property and at the same time overstate their income. State escheatment law dictates that unclaimed property must revert to the state, where, if unclaimed, the value has public benefit and where reuniting owners and property is pursued through focused efforts and facilitated through a centralized database.

Code of Civil Procedure Section 1571 permits the Controller to, "at reasonable times and upon reasonable notice examine the records of any person if the Controller has reason

to believe that the person is a holder who has failed to report property that should have been reported pursuant to this chapter.” Based on past examinations, the SCO estimates a 10-1 benefit-cost ratio for each new position established.

Like the Board of Equalization and Franchise Tax Board, the SCO faces difficult recruitment problems in the auditor classifications. For example, ten SCO auditor positions authorized by the 2005 Budget Act to audit mandate claims were only just filled. The SCO has cited the limited-term nature of these ten positions as a major obstacle to hiring.

An alternative to filling these positions on a limited-term basis would be to authorize them on a permanent basis and require reporting on the performance of the positions. This information will enable the Administration and Legislature to evaluate, each year, the efficacy of the positions and determine whether adjustments to reduce or augment positions are merited.

There is precedent for this type of annual reporting. The Franchise Tax Board currently provides an annual report on its auditor and collector activities. This information is used to evaluate performance and suggest where resources should be adjusted.

Staff Recommendation: AMEND the proposal by making the 15 positions permanent and add supplemental report language requiring ongoing reporting on unclaimed property audits, including audit findings, amount of collections, the number of individuals reunited with their property, and the amount the SCO disbursed to owners through this effort.

3. Unclaimed Property Program Staffing

The SCO requests \$554,000 General Fund and 7.2 positions to handle increased workload associated with notifying owners of unclaimed property, facilitating auctions of safe deposit boxes, and providing operational support to Unclaimed Property Program management. The SCO's request consists of the following three components:

- 2.6 permanent positions for increased workload associated with the mailing of Franchise Tax Board (FTB) notices to owners of unclaimed property.
- 2.1 permanent positions for workload associated with the auctions of safe deposit box contents.
- 2.5 permanent positions for operational support to the Unclaimed Property Program (UCP) management.

The SCO has explained that if the unclaimed property workload positions for FTB notices and auctions are not approved, service delivery and unclaimed property auctions would be degraded. Unclaimed property auction revenues would decrease from \$1.6 million to \$1 million annually by 2007, based on reduced capacity to operate online auctions.

Staff Comment: This issue was previously considered at the March 23, 2006, hearing. Staff recommendation was to (1) amend the request for 2.6 FTB notice positions and 2.1 safe deposit box unit positions, by making them three-year limited-term, and (2) reject the request for 2.5 positions for operational support. The Subcommittee action was to leave the issue open for further discussions between the department and staff.

Comments from the March 23 agenda were:

The Budget Change Proposal (BCP) notes that in the last two years the UCP has been able to redirect 14 positions for FTB notices and safe deposit box resolution workloads, but that ongoing redirections will undermine their ability to meet other workloads. A redirection equal to five percent of approximately 128 program personnel is considerable. Of the 14 redirections, all were redirected from other divisions.

The 2.5 operational support positions are a new workload request. The proposed staff would conduct legal research, fraud detection and prevention, special projects, customer service, legislation, and other staff work.

Recognizing the SCO's considerable capacity for staff redirections, redirections may also be used for the new operational support activity, perhaps using staff previously redirected from other divisions. Furthermore, many of the proposed operational support activities are germane to other divisions (e.g. legal research, fraud detection, legislation, and customer service) and could be absorbed by, or using staff from, other SCO divisions.

Staff notes that while Unclaimed Property Program activity has surged in recent years, the ongoing workload is less certain as more citizens learn how to recover their property and new technological capacities to reunite owners with their property become available.

The Legislature should revisit workload trends for FTB notice positions (2.6) and safe deposit box positions (2.1) at a later date and ascertain whether redirections may again be possible.

The SCO has responded to both staff recommendations. The SCO has provided clarification on the growing workload of the notice and safety deposit box activities that suggest the positions not be confined to two-years limited-term. With the operational support positions, while demonstrable workload exists, it is not clear that a share of the redirections (14 positions from other divisions) cannot be ongoing for this 2.5 position workload. Furthermore, the nature of operational support work is such that some of it could be assigned to other personnel as a secondary duty, including the newly established notice and safety deposit box positions.

Staff Recommendation: AMEND the BCP by rejecting the request for 2.5 positions for operational support.

VOTE:

0845 Department of Insurance

Under the leadership of the state's Insurance Commissioner, the Department of Insurance regulates the largest insurance market in the United States with over \$115 billion in direct premiums written in the state. The Department conducts examinations and investigations of insurance companies and producers to ensure that operations are consistent with the requirements of the Insurance Code and those insurance companies are financially able to meet their obligations to policyholders and claimants. The Department also investigates complaints and responds to consumer inquiries; administers the conservation and liquidation of insolvent and delinquent insurance companies; reviews and approves insurance rates; and combats insurance fraud.

The Governor's budget funds 1,272.9 positions (including 13 new positions) and expenditures of \$197.6 million.

DISCUSSION ISSUE

BCP: Implementation of Patient and Provider Protection Act

The Department of Insurance (DOI) requests ten positions and \$1.2 million (Insurance Fund) to implement the provisions of Chapter 723, Statutes of 2005 (SB 367). This law required the department to process complaints and inquiries from insureds and their health care providers. This law also required the department to provide information concerning the process for filing complaints and making inquiries concerning health insurers. These positions will field those complaints and investigate unfair claims practices found during these processes.

Staff Comment: This issue was heard on April 6, 2006, and held open pending additional information and reconciliation of the appropriate staffing level. The LAO had recommended funding five positions for this new function, half of the Administration's ten position request. Senator Speier's office, the Patient and Provider Protection Act sponsor, has recommended to subcommittee staff and DOI staff funding eight positions. Eight positions would be the same staffing level as that currently existing in the Department of Managed Health Care (DMHC) for a similar provider complaint function. The LAO and DOI have indicated their support for this staffing level.

A lingering question raised at the April 6 hearing was whether the DMHC workload is the same as the workload anticipated by the DOI. A fundamental difference exists in that DMHC regulates HMO's and other similar health plans, whereas the DOI regulates indemnity plans where (in most cases) there are no contracts between the providers and the insurers. The lack of a contract makes the DOI workload ripe for disputes over how much should be paid to the provider on a health insurance claim. Consequently, the DOI should expect a higher percentage of provider complaints on indemnity plans than on HMO plans regulated by DMHC.

The LAO has recommended and the Assembly Budget Subcommittee has adopted supplemental report language requiring the DOI to report annually for three years on its workload and staffing requirements in implementing SB 367, and, if workload is insufficient, submit a negative BCP to correct staffing levels. At the April 6, 2006, hearing, the Administration and DOI raised no objections to this reporting language.

Staff Recommendation: REDUCE the BCP by two positions (fund eight total) and adopt Supplemental Report Language requiring the DOI to report annually for three years to the Legislature on its workload and staffing requirements in implementing SB 367.

VOTE:

0860 Board of Equalization

The State Board of Equalization (BOE), the Franchise Tax Board (FTB), and the Employment Development Department (EDD) are the state's major tax collection agencies. The BOE collects state and local sales and use taxes and a variety of business and excise taxes and fees, including those levied on gasoline and diesel fuel, alcoholic beverages and cigarettes, as well as others. BOE also assesses utility property for local property tax purposes, oversees the administration of local property tax by county assessors, and serves as the appellate body to hear specified tax appeals, including FTB decisions under the personal income tax and bank and corporation tax laws.

The Governor's budget funds 3,802.9 positions (including 64.5 new positions) and proposes \$370.6 million in total expenditures (\$212.8 million General Fund).

DISCUSSION ISSUES

1. Tax Gap Proposals

At the March 9, 2006, hearing, the Subcommittee heard how the state faces a \$7.9 billion tax gap problem. The tax gap is simply the difference between what individual and business taxpayers should pay and what is actually paid. The tax gap shortfall is comprised of \$6.5 billion in personal income and corporation tax and a \$1.4 billion gap in sales and use tax payments. With California expected to collect \$87.7 billion General Fund in the current year, this lost revenue amounts to nine percent of total annual General Fund revenue.

At that March hearing, the Subcommittee heard how the tax gap is harmful to the state in many ways, but principally because: (1) those who pay their fair share pay higher taxes to cover the gap, and (2) tax collections are undermined by the public perception that some are not paying their fair share. A key solution to addressing the structural deficit (while at the same time strengthening the fairness of the state's tax system) is closing the tax gap.

The Board of Equalization (BOE) bases their most recent estimate of the tax gap on the total amount of state sales and use tax that was due during the 2004-05 fiscal year, which amounted to approximately \$28.2 billion. (For local agencies, who BOE also collects for, the total amount due is \$14.5 billion. This discussion will not address local agencies' tax gap.) Of the \$28.2 billion that should have been collected, \$26.9 billion or 95.2 percent was paid voluntarily by those businesses registered with the Board. Without rounding, the gross state sales and use tax gap is \$1.4 billion or 4.8 percent of the total amount of sales and use taxes due. The sales and use tax gap is largely a use tax shortfall.

The following proposals will begin to address the tax gap and restore fairness to the tax system.

A. Audit Selection Improvements

As the LAO noted in their *Analysis of the 2006-07 Budget*, “improving audit selection—through discovery audits or other improvements in audit selection methods—represent more fundamental approaches to dealing with noncompliance.”

The BOE has adopted several new processes to refine their auditing selection. In 2004-05, the BOE decentralized some of its audit selection to enable local districts to better focus their audits and refined audit selection at the headquarters level to include more businesses that had not been audited in several years. That same year, BOE purchased a “NameSearch” software to enable them to match accounts with external agency data using only a name. This software has boosted matching across accounts from 15 percent to 70 percent.

Through these refinements, the BOE learned that selections will improve if additional data and resources are used to select audits. To that end, additional data is now coming from FTB, the IRS, EDD, and the U. S. Custom’s Service.

The BOE has reformed internal processes, too. It now provides audit staff with the reason the account was selected for audit and results of past audits, if available. The BOE is also identifying “priority” accounts to ensure the largest taxpayers are audited in a timely manner. In 2006-07, the BOE plans to implement several new procedures to refine audit selection, including:

- Utilizing new software called Clementine, which will enhance the department’s audit selection capabilities by improving data sorting capabilities.
- Putting U.S. Customs data into the audit selection database for local district use.
- Extending the time allowed for audit selection, in order to facilitate more careful selections.
- Sharing information with local districts on the deductions claimed by taxpayers on their returns.
- Making greater use of data from the FTB’s integrated Nonfiler Compliance (INC) database to identify taxpayers who may be underreporting Sales and Use Tax liabilities.
- Utilizing North American Industry Classification System data to identify tax underreporters.

Staff Recommendation: ADOPT supplemental report language directing the Board of Equalization to report annually on the outcomes of each of the audit selection enhancements outlined above, additional revenues generated through those methods, and identification of other audit selection improvements where additional resources would close the tax gap further.

B. Targeted Sales and Use Tax Audits

The LAO, in their *Analysis of the 2006-07 Budget* noted that:

the BOE has identified use tax noncompliance by service industry businesses as a major contributor to the tax gap. For example, many professional offices and consulting firms use equipment and furniture purchased from out of state, but fail to pay the use tax owed to California on such items. This may be due to either inadvertent or willful actions on the part of businesses. Despite the importance of

this sector as a contributor to the tax gap, neither the BOE nor the administration has put forth a proposal to address it.

The LAO recommended the BOE establish a pilot program of targeted audits for selected service industries regarding use tax compliance.

In response, the BOE pointed to an existing program, the audit of U.S. Customs data and the results achieved this year.

U.S. CUSTOMS DATA MINING

The current year Budget Act includes one position designated to mine U.S. Customs data sent to the department. The workload is based on a recent pilot project that reviewed data on over one million individual quarterly transactions for items imported through California's commercial ports of entry and then collecting use tax due. The results from that pilot were surprising: over \$6400 in collections per hour of work.

In 2005-06 budget development, Subcommittee staff recommended the addition of two additional positions for this activity, noting that the positions would generate an additional \$2.3 million in the budget year and subsequent year. The BOE declined to support that recommendation, instead requesting a year to see if the pilot results would be borne out.

The pilot results have been borne out and then some. Despite filling the position only early in 2006, revenues were \$220,000 by the end of February, \$743,000 by the end of March, and on track to collect \$1.5 million. This \$900,000 budgeted will be well exceeded.

One position will process a lead and send approximately 300 letters a month, or 3600/year. The department expects to receive 10,000 leads a year, and, when combined with the 2004 and 2005 backlog, suggests that five positions are more appropriate to address the backlog.

Assuming each position generates \$1.2 million/year (a conservative estimate based on current year outcomes), the addition of four new positions would generate \$4.8 million in new revenues (at a cost of \$260,000) and restore some fairness to the tax system. While the department has indicated that they intend to request positions next year for this purpose, there is no apparent reason to wait until 2007-08 to address this obvious tax gap problem.

OTHER TARGETED SALES TAX AUDIT

At the request of Assembly Budget staff, the BOE has embarked on a pilot project with a major "big box" retailer to determine the level of retail sales certificates fraud. This involves verifying that the reseller is in fact a business, or alternatively, examining whether purchasers of a large quantify of items did in fact report those items as resold. If they did not, it suggests that sales may have occurred but not been reported.

Preliminary findings of this targeted sales tax audit suggest that the BOE should establish a dedicated program for retail sales certificate audits.

Staff Recommendation:

1. Request the BOE report on preliminary findings of the “big box” pilot and what resources would be prudent to implement this tax gap solution.
2. Request that the BOE report on additional targeted use tax audits for specified service and professional businesses, including educational and enforcement aspects of such audits and estimated revenue impacts.
3. Augment the BOE’s U.S. Customs data mining efforts by four two-year limited term Tax Technician III positions and associated costs (an augmentation of approximately \$260,000 General Fund) and budget the \$4.8 million in new General Fund revenues.

VOTE:**C. Business Property Reporting Requirement**

In their *Analysis of the 2006-07 Budget*, the LAO suggests that the BOE expand the business property reporting form and require filing with the BOE, as well as county assessors. Local county assessors receive annual property tax statements from businesses related to their personal property holdings. Including information regarding sales or use tax paid on acquisitions of the property identified on the statements and allowing that information to be shared with the BOE would facilitate the administration of sales and use tax laws and generate new tax revenues.

Although the Board prescribes many types of forms for use by assessors, taxpayers must obtain the business property statement and any other required forms from the county in which the taxable property is owned, claimed, possessed, controlled or managed. Taxpayers report their personal property holdings by year of acquisition in lump sum amounts that are broken down by a few broad category types. Redesigning the form to allow reporting by specific categories and use tax liability would better enable the BOE to identify noncompliance with property tax laws.

The BOE has recently stated that it is negotiating with the County Assessors to standardize the business property statement form and add a use tax question. Sharing business property statement information will also facilitate the administration of tax laws.

Staff Recommendations:

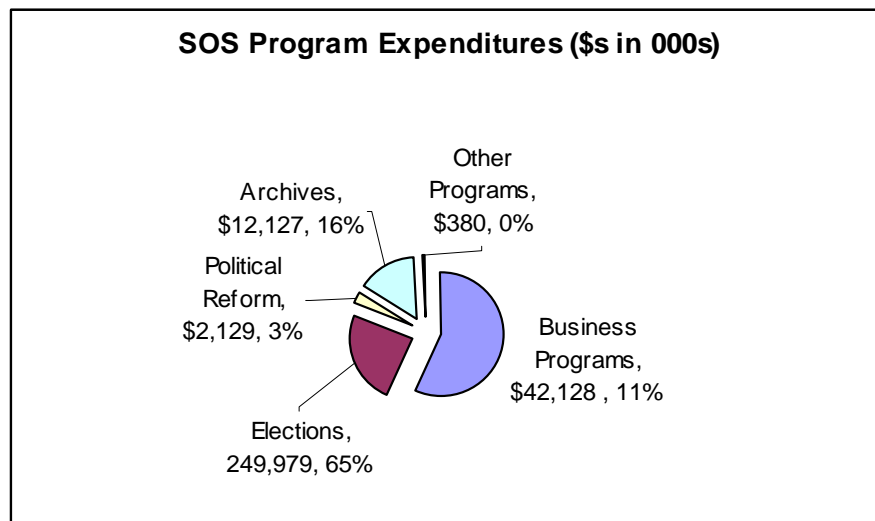
1. Request the BOE report on the status of negotiations with county assessors, any concerns with implementing this requirement statutorily, confidentiality issues, and provide a revenue estimate based on information from this reporting.
2. Direct staff to prepare legislation requiring the sharing of disaggregated business property reporting information between localities and the state.

VOTE:

0890 Secretary of State

The Secretary of State (SOS), a constitutionally established office, is the chief election officer of the state and is responsible for the administration and enforcement of election laws. The office is also responsible for the administration and enforcement of laws pertaining to filing documents associated with corporations, limited partnerships, and the perfection of security agreements. In addition, the office is responsible for the appointment of notaries public, enforcement of notary law and preservation of certain records with historical significance. All documents filed with the office are a matter of public record and of historical importance. The Secretary of State's executive staff determines policy and administration for Elections, Political Reform, Business Programs, Archives, and Information Technology and Management Services Divisions.

The Governor's budget funds 484.5 positions (including 31 new positions) and budget expenditures of \$77.2 million (\$32.0 million General Fund).



VOTE-ONLY ITEMS

A. Finance Letter: Business Programs Automation

The Secretary of State requests \$2.210 million (Business Fees Fund), including \$1.831 million ongoing to fund the maintenance and operation costs of data services and programming of the Uniform Commercial Code (UCC) automated system. The SOS is responsible for filing and sharing certain financing statements through this system. The SOS requests to offset this augmentation by \$255,000 by reducing three IT positions that will no longer be needed. Fees collected for filing financing statements will fund this augmentation.

B. BCP: Forensic Leak Assessment and Security System Replacement

The Secretary of State requests a one-time expenditure authority of \$625,000 (Business Fees Fund) to conduct a forensic leak assessment and replace the security monitoring system at the Secretary of State and State Archives Building Complex. Similar to the Board of Equalization Building on N Street in Sacramento, the Secretary of State has

encountered water intrusion problems during heavy weather, resulting in concerns about mold-related illnesses. The CHP conducted a building security assessment in 2002 and recommended upgrades to the video surveillance system.

DISCUSSION ITEMS

1. Help America Vote Act (HAVA) Spending

In the fall of 2002, Congress passed and the President signed legislation to fund improvements to states' election systems. HAVA funds have been appropriated nationwide with the direction to implement broad election reforms and improve the accuracy and performance of each state's voting processes. For California, these activities include developing a statewide voter database, voter outreach, poll monitoring, replacing punch card voting machines with more modern equipment, and other related activities. Since establishment, California has received \$361.6 million in federal funds to implement mandates affecting the administration of federal elections. The 2005-06 budget reappropriated \$201.7 million in federal funds for these purposes.

The 2006-07 Governor's budget did not incorporate the spending plan for the remaining federal HAVA funds, approved by the Legislature in April 2005. Instead, the Administration has provided a current year budget control section letter, a Finance Letter request for the budget year, and a revised expenditure plan for the Legislature to consider.

CURRENT YEAR BUDGET CONTROL SECTION LETTER.

The Administration requests additional current year federal fund expenditure authority of \$4.313 million for costs associated with the statewide database interim solution (CalVoter upgrade), county costs associated with implementing that interim solution, voting systems guidelines and procedures, and parallel monitoring of polling machines.

FINANCE LETTER

On April 18, 2006, the Administration submitted a Spring Finance Letter proposing \$5.5 million in new budget year expenditures. This includes initial costs for the new statewide database (\$2.1 million), interim solution, poll monitoring, parallel monitoring, voting system assessments, and voter education materials. Additionally, the request includes reappropriation requests for \$46 million in HAVA funds. The reappropriation will fund HAVA activities previously approved but have fallen behind schedule.

REVISED EXPENDITURE PLAN

The Secretary of State's new plan reduces HAVA expenditures and addresses concerns raised by the Joint Legislative Budget Committee regarding the appropriate expenditure of federal funds. The overall JLBC concern was that the SOS needed a new and comprehensive proposal for spending HAVA funds. The JLBC recommended the Secretary of State provide a plan that did not commit the General Fund to paying for the statewide voter database, and advised them to cease all discretionary HAVA activities, other than spending on county grants.

The revised proposal reflects several changes relative to the current plan, including:

- Increases costs for the VoteCal statewide voter database (from \$47 million to \$67 million).
- Eliminates county training grants for training local officials and poll workers (reduction of \$9.5 million).

- Eliminates General Fund support for the VoteCal statewide voter database (savings of \$19 million General Fund in out years).
- Eliminates source code review which would involve contracting with independent experts to review and analyze the source codes used in voting machines and associated devices (reduction of \$1.2 million).
- Eliminates federal audit requirement (reduction of \$1.5 million). This audit will be paid for by counties who are actually subject to the audit.
- Reduces funding for county security based on reimbursement claims received to date (reduction of \$2.6 million).

Staff Recommendation: Request the Secretary of State:

1. Describe the overall changes included in the revised expenditure plan, identifying deficiencies that were identified and corrected relative to the April 2005-approved plan.
2. Explain why funding for independent examination of voting systems' source codes is no longer needed.
3. Identify steps being taken to ensure that the contract for a statewide database provides sufficient financial protections for the state in case of unexpected events.
4. Identify steps being taken to ensure that the department does not exceed its fiscal authority in the future.

2. BCP: Notary Public Applications

The Secretary of State requests \$3.132 million (Business Fees Fund) and 30 positions to augment the Secretary of State's capacity to process notary applications and conduct background checks. Of the 30 requested positions, 7 would be two-year limited-term. The requested positions would address an anticipated rise in notary applications and allow for more hearings into notarial misconduct.

A Notary Public is a public servant appointed by state government to witness the signing of important documents and administer oaths. The state will have 281,444 notaries public as of July 1, 2006. This equals 133 persons per notary public. Notaries are commissioned on a four-year term.

Staff Comment: According to the Secretary of State, the number of applications received and processed has grown from 50,000 in 2000-01 to 122,000 in 2004-05. The SOS attributes this growth largely to the housing market and a "strong" level of mortgage refinancing, reverse mortgages, and home equity loans. The SOS has met this workload using 12.5 permanent positions and 12 limited-term positions. The 12 limited-term positions will expire this year.

In the current year, the SOS estimates 144,000 in applications. However, as of March 31, the department had received only 89,000 applications. Based on that the number actually received, it appears the department will receive 119,000 applications in the current year. Adopting the SOS growth rate of 18 percent growth rate in 2006-07, the number of applications should be 140,000—30,000 less than the 170,000 anticipated in the proposal. (Staff notes that the 18 percent growth rate was not based on any

economic analysis related to the level of mortgage refinancing, reverse mortgages, and home equity loans. Eighteen percent is simply the growth rate in 2004-05.)

Adopting the SOS's 18 percent growth rate, the appropriate level of staffing is 16, rather than the 20 additional notary application processing positions requested.

The SOS has included in the BCP a request for ten additional positions to address an anticipated but not existent caseload in the Notary Investigations and Enforcement Unit. Given the unknown economic and workload trends identified above, there is no clear justification for additional investigation positions at this time.

There is no backlog in the investigations and enforcement unit. Without the identification of a backlog, it is difficult to know how much additional workload the department can absorb or reorient its current service delivery practices. For example, the SOS has explained that they have recently begun accommodating potential notaries to a greater degree by traveling to the applicants, rather than hosting applicants at a central site and event. Reducing that service will free up staff time for other workloads.

Given the highly speculative nature of the real estate market, it is very difficult to accurately predict notary workload before it actually materializes. If it does materialize, the Legislature may wish to consider funding additional staff in a subsequent budget year.

OPERATING EXPENSE

Components to the operating expense allocation (OE) accompanying these positions are unusually high. The department was not able to identify the basis for their OE calculations, other than to state that they have been at that level since 1999. The department relies on this past practice for budgeting of printing, communications, postage, training, consolidated data centers, and data processing costs. Funding for these items are approximately 50 percent greater than what other departments charge.

Furthermore, since this high OE complement level for new positions has been the practice since at least 1999, an excessive amount of OE has accrued in the Secretary of State budget.

Funds not spent from the Business Fees Fund are transferred to the General Fund and treated as revenues.

Staff Recommendation:

1. AMEND the request by approving the establishment of 16 notary processing positions for two years limited-term.
2. AMEND the operating expense complements for the 16 positions authorized, reducing the printing, communications, postage, training, consolidated data centers, and data processing funding by one-half (savings of approximately \$64,000)
3. Request that the SOS research their OE cost basis and provide that information with subsequent budget change requests.

VOTE:

3. BCP: Records Processing Backlog

The Secretary of State requests \$295,000 General Fund and one Archivist II position to address the backlog of archival records and to establish a program to prevent future backlogs. The SOS will also utilize 12 graduate student interns to address the backlog of processing and organizing deposited materials.

Staff Comment: As described above, components to the operating expense allocation accompanying this position appeared unusually high and were unverifiable. Specifically, in the budgeting of printing, communications, postage, training, consolidated data centers, and data processing, the department is relying on past practice only. Funding for these items are approximately 50 percent greater than other departments.

Staff Recommendation: AMEND the BCP request by reducing funding for the specified OE items by 50 percent to reflect a more reasonable estimate of costs (savings of \$5000).

VOTE:

1730 Franchise Tax Board

The Franchise Tax Board (FTB) administers state personal income tax and corporation taxes for the State of California, collects debt on behalf of other state agencies and local entities, and performs audits of campaign statements and lobbyist reports authorized by the Political Reform Act of 1974. The FTB is tasked to correctly apply the laws enacted by the Legislature; to determine the reasonable meaning of various code provisions in light of the legislative purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view. The Governor's budget funds 5,160.4 positions (including 32.5 new positions) and expenditures of \$662.4 million (\$499.2 million General Fund).

A. Finance Letter: Tax Gap and Discovery Audit Programs: Full Year Annualization of Costs

The Administration requests \$659,000 General Fund to request the full year cost of positions established in the 2005 Budget Act at a partial year rate. This adjustment will enable full implementation of programs established by the Legislature last year.

B. Finance Letter: Occupancy Costs for the Butterfield Office Complex

The Administration requests \$21.611 million General Fund, \$101,000 Motor Vehicle Account, \$188,000 Motor Vehicle License Fees, \$282,000 Court Collection Account, \$1.854 million reimbursements, and \$82,000 from the Political Reform Act budget (for a total of \$24.1 million) to fund increased rental costs and service expenses at the FTB's main office in Sacramento. DGS has directed FTB to transition to a full service billing fee structure, which the proposed funding would provide.

VOTE on Vote-Only Issues A and B:

DISCUSSION ISSUE

1. Auditor Recruitment and Retention

Both of the state's major tax agencies face significant challenges in filling positions and retaining staff in audit positions. At the FTB, the department is concerned that the dual threat of staff loss and hiring difficulties are rising and will eventually jeopardize the department's ability to generate revenues.

A primary factor for staff losses and hiring difficulties are that compensation for an *experienced* auditor does not match what the private sector provides. The FTB is concerned about the training and developing they devote to staff, only to see them leave for higher paying private sector employment. The departure of experienced staff also has the secondary effect of keeping the average experience level low at the department.

The FTB has a large staff need and many competitors. The FTB has 600 auditors and program specialists working in 13 locations. The department competes for auditors with the private sector, IRS, and many other state and local departments. Furthermore, the passage of the federal Sarbanes-Oxley Act has dramatically increased the demand for auditors in all sectors of the economy.

The FTB cites salary competitiveness as one important component to addressing the retention and recruitment problems. The DPA is currently examining auditor salaries and is expected to release a report soon detailing how state auditor salaries differentiate from other sectors of the economy.

Currently, the FTB has 40 vacancies above their normal salary savings level. Based on the average of \$1 million in revenues collected per auditor per year, the state stands to lose approximately \$40 million this year in collections by FTB audit staff.

The audit program at FTB produces over \$1 billion in revenue a year. Given the \$6.5 billion tax gap, there is every good reason to believe that more auditors are needed, making this trend all the more alarming.

Staff Recommendation: Request the FTB to report on their:

1. Plan for increasing salaries to be competitive and any DPA findings that would substantiate a change.
2. Plan and strategies for recruitment and retention (in addition to salary changes).
3. Updated 2006-07 revenue loss projection due to excess vacancies.

1955 Department of Technology Services

The Department of Technology Services (DTS) is the result of reorganization and consolidation of the Stephen P. Teale Data Center (Teale), the Health and Human Services Data Center (HHSDC), and certain telecommunications functions of the Department of General Services. The Department of Technology Services (DTS) serves the common technology needs of Executive Branch agencies and other public entities with accountability to customers for providing secure services that are responsive to their needs and represent best value to the state. A Technology Services Board provides governance and guidance to the DTS.

The Governor's budget funds \$235 million in expenditures from the DTS Revolving Fund and 775.2 positions (no new positions). Several proposals to expand services are offset by a decrease due to one-time spending in 2005-06.

Budget Change Proposals Proposed for Vote-Only

A. Child Welfare System/Case Management System Application Hosting Move

The Administration proposes \$4.0 million (DTS Revolving Fund) to enable the department to move this system from an IBM data center in Colorado to a state data center. The Administration asserts that this move is necessary to comply with a federal directive and protect the CWS/CMS in state.

B. Prior Year Project Expenditure Adjustments

The Administration requests to adjust the DTS' baseline budget to reflect estimated project costs in the current and budget years. The net effect of these adjustments will be to reduce expenditures by \$5.5 million in the budget year. The DTS is a fee-for-service organization and operates solely upon reimbursements. This BCP requests the funding authority needed to meet customer's needs and requirements.

C. Mainframe CPU Processing Capacity

The Administration requests \$5.7 million (DTS Revolving Fund) to purchase mainframe processing capacity in order to meet projected workload increases and upgrade software. The DTS anticipates a need for 962 additional Millions of Instructions Per Second (MIPS) in the budget year. This capacity growth need is primarily driven by population growth and the corresponding impact on departments' IT needs.

D. Midrange Computing Capacity Augmentation (Server Upgrades)

The Administration requests \$4.1 million (DTS Revolving Fund) to allow for the replacement of 45 UNIX and 70 Windows servers with 120 new Windows servers and 10 UNIX servers. The DTS has identified a customer-driven workload and notes that vendor options become narrower as new technology replaces older servers, particularly in the area of security software.

E. Enterprise Storage

The Administration requests \$1.189 million in 2006-07 (DTS Revolving Fund) to purchase and upgrade existing data storage capacity, as well as enhance connectivity infrastructure, in order to meet anticipated growth needs of DTS' more than 450 customers. Specific needs have been identified in the mainframe storage capacity, midrange storage capacity, tape storage capacity, and connectivity infrastructure.

F. Network Workload Growth

The Administration requests a \$4.678 million increase in DTS Revolving Fund spending authority to purchase hardware and higher bandwidth circuits. The department requests increased spending authority to upgrade capacity for Internet connectivity, accommodate workload growth in their support for the California Child Support Automation System, upgrade the backbone router, and replace old firewall infrastructure.

VOTE on Vote-Only Issues A through F:

DISCUSSION ISSUE

1. Unrealized Consolidation Savings and Efficiencies

The LAO has noted, in their *Analysis of the 2006-07 Budget*, that efficiencies anticipated from consolidating data centers were not clearly identified in the Governor's Budget.

LAO Comment: The Legislature began the process of consolidating the state's data centers in 2003-04 as a way to make the state's IT operations more efficient. For instance, a consolidated data center can use its purchasing power to negotiate better prices on hardware and software. In addition, many administrative functions can be merged to reduce staff demands.

The Governor's budget includes no savings associated with the creation of DTS. The department reports that it is currently reviewing its operations to identify efficiencies in five areas (1) IT contracts for hardware and software, (2) other types of contracts, such as security, (3) facilities, (4) personnel and resources, and (5) telecommunications and networks.

The DTS has identified potential savings of \$4 million annually related to facilities. At the time this analysis was prepared, however, it had not completed estimates for the other areas.

The department should continue its efficiencies planning and report to the Legislature during budget hearings on expected savings. While some savings may require long-term efforts, we would expect other efficiencies to be implemented in the near term. Any savings for 2006-07 should be integrated into the department's budget proposal during the spring budget process. These savings would then be reflected in reduced rates for DTS' customer departments. Pending the receipt and review of such a proposal, we withhold recommendation on the department's budget.

Staff Comment: In meeting with staff, the DTS explained that starting in the current year, they do expect consolidation savings to be realized. The DTS expects savings of \$47.6 million to accrue between 2005-06 and 2008-09 in the facilities, contracts, network operations, and personnel areas. The department has established savings targets for each of the four years. (A May Revision budget adjustment is expected to capture 2006-07 savings.)

Staff Recommendation: Request the DTS report on consolidation savings, including how those savings were identified, number of departments affected, and total savings by each of the following categories: (1) IT contracts for hardware and software, (2) other types of contracts, such as security, (3) facilities, (4) personnel and resources, and (5) telecommunications and networks.

8620 Fair Political Practices Commission

The Fair Political Practices Commission has primary responsibility for the impartial administration, implementation, and enforcement of the Political Reform Act of 1974. The objectives of the Political Reform Act are to ensure that election campaign expenditure data is fully and accurately disclosed so that the voters may be fully informed and to inhibit improper financial practices, and regulate the activities of lobbyists and disclose their finances to prevent any improper influencing of public officials.

The Governor's budget proposes 73.4 positions (including 14 new positions) and expenditures of \$7.002 million in 2006-07. Between 2004-05 and 2006-07, FPPC staffing is expected to grow by 30 percent, from 56.8 positions to 73.4 positions.

VOTE-ONLY ITEM

Extension of "Revolving Door" Provision to Local Officials

The FPPC requests \$164,000 and 1.8 positions to meet newly established statutory workload. Chapter 680, Statutes of 2005 (SB 8, Soto) extended the one-year preclusion from lobbying to local elected officials, county chief administrative officers, city managers and administrators, and special district general managers and chief administrators. The additional staff will handle telephone and written advice, legal advice and opinions, and enforcement workload.

VOTE on Vote-Only Item:

DISCUSSION ITEM

Staffing Augmentation for Increased Workload

The Governor's budget includes \$700,000 General Fund and 12.2 positions to meet workload requirements stemming from new Legislative mandates and the Political Reform Act. Caseloads and backlogs have increased considerably in recent years: in the enforcement division, new cases nearly doubled from 892 in 2003 to 1751 in 2004. The requested positions will be assigned to enforcement, investigations, legal counsel, legal support, and administrative support. Revenues in the range of \$90,000 to \$120,000 are expected from enforcement actions.

Staff Comment: The BCP request did not include an operating expense (OE) complement. Without this funding the department would have to either absorb or request at later date the communications, computer equipment, data support, furniture, and other items normally accompanying new positions. At staff request, the FPPC modified their request to recognize an appropriate level of OE. The same number of positions are be requested, however, the position classifications have been adjusted slightly to recognize \$43,000 in OE.

Staff Recommendation: AMEND the proposal to recognize the \$43,000 OE complement. (This change will result in no change to overall cost or number of positions.)

VOTE:

8940 MILITARY DEPARTMENT

The Military Department is responsible for the command, leadership and management of the California Army and Air National Guard and five other related programs. The purpose of the California National Guard is to provide military service supporting this state and the nation. The three missions of the California National Guard are to provide: (1) mission ready forces to the federal government as directed by the President; (2) emergency public safety support to civil authorities as directed by the Governor; and (3) support to the community as approved by proper authority. In addition to the funding that flows through the State Treasury, the Military Department also receives federal funding directly from the Department of Defense.

The Governor's budget funds 685.9 positions (including 17 new positions) and \$111.5 million in expenditures (\$38.1 million General Fund, \$62.0 federal funds, and \$11.4 in other funds and reimbursements).

VOTE-ONLY ITEM

A. Finance Letter: State Active Duty Increase

The Administration requests a decrease of \$470,000 (\$112,000 General Fund) to reflect the net effect of the annual Congressionally-mandated State Active Duty pay adjustment, effective January 1, 2006.

VOTE on Vote-Only Item:

DISCUSSION ITEMS

1. Finance Letter: Second Youth Challenge Program

The Administration requests \$3.9 million (\$900,000 General Fund) and 17.8 positions in 2006-07, and \$3.3 million (\$1.4 million General Fund) and 29 positions in 2007-08 to establish a second Youth Challenge Program that will serve at-risk 16 – 18 year-olds who have dropped out of school, are unemployed, and meet other criteria. The Military Department received a one-time federal appropriation of \$1.7 million to develop facilities to support a new 200 person complex. The federal government will contribute \$1.9 million ongoing for this program.

The U.S. Congress established the Youth ChalleNGe program in 1992 to address a burgeoning problem with school drop-outs. The first Youth ChalleNGe Program was established in California in 1998 at Camp San Luis Obispo. That program currently accepts 300 students a year in two classes (150 per class), and graduates about 100 per class. (Students drop out for various reasons, including drug use, violation of camp rules, or voluntarily.) Student placement data shows that since inception, between 67 and 91 percent of program graduates have returned to school and/or gone into full-time employment.

The department currently turns away approximately 400 students annually from Camp San Luis Obispo due to insufficient class space. The new facility at Los Alamitos would alleviate some of the demand by accepting 200 students a year.

Staff Comment: No less than at the time Camp San Luis Obispo was first established, a Youth Challenge program at Los Alamitos suggests that the Legislature examine the policy of using the state's military resources to rehabilitate at-risk youth. Additionally, alternative funding options such as requiring local beneficiaries to bear the expense or diverting resources from other prevention programs should be explored.

Staff Recommendation: Request the department respond to the staff comments, explaining specifically why this is a role for the military department, efforts taken to identify other funding sources for the Los Alamitos facility, and why this matter is not better evaluated by a policy committee.

2. Civil Support Retention Team Bonus

The California Military Department requests \$85,000 General Fund for annual retention bonuses of \$2000 each to 44 members of the Weapons of Mass Destruction Civil Support Teams. These payments are consistent with AB 690 (Saldana, 2005), which authorizes a state retention bonus in the amount of \$2,000 to be awarded annually to a member of the California National Guard serving on the Weapons of Mass Destruction Civil Support Team, provided that the member is a certified hazardous materials specialist or technician. The \$85,000 requested includes application of a 97 percent staffing ratio.

Staff Comment: This issue was held open on March 9 and staff directed to review the statutory requirement. Chapter 155, Statutes of 2005 authorized a state retention bonus in the amount of \$2,000 to be awarded annually to a member of the California National Guard Weapons of Mass Destruction Civil Support Team, as specified, provided that the member is a certified hazardous materials specialist or technician. The policy committee (Veterans Affairs) may be the more appropriate venue to amend this law.

Staff Recommendation: APPROVE the BCP.

VOTE:

3. Headquarters Complex

The California Military Department requests \$1 million General Fund to acquire a two-year purchase option on 30 acres of land at the former Mather Air Base. This purchase option is intended to secure land for later construction of a new headquarters complex. The new headquarters complex would be a four-story complex including offices, personnel and work areas, a cafeteria, lockers and fitness center, assembly hall, classrooms, conference rooms, and other spaces deemed necessary for a headquarters complex. The current estimate for the entire project (design through construction) is \$98.5 million (\$34.4 million General Fund and \$64.1 million federal funds). Six facilities in Sacramento and in San Luis Obispo would be consolidated into the new space.

The lease on the existing headquarters facility extends through 2017. The establishment of a new headquarters building (from design to occupancy) will take approximately six years.

Staff Comment: At the March 9, 2006, hearing, the Subcommittee held open the request and directed the department to provide staff with a department space

management plan. In response, the department has provided information on their statewide properties and replacement/restoration plans, and clarified the financial benefits of purchasing the headquarters facility. The new headquarters complex is expected to save the state between \$31 and \$46 million over the life of the lease-revenue bond, relative to the current lease cost. Additionally, the new facility will meet federal force protection requirements.

This BCP represents a commitment by the state to build a headquarters facility at Mather Air Field at an estimated state cost of \$34 million General Fund, matched by \$64 million in federal funds.

Over 90 percent of the state's 109 armories are over 40 years old, a situation that has created a pressing need to upgrade or replace these facilities. The department's latest Five-Year Infrastructure plan lays out the department's project priorities, including the creation or overhaul of nine armories. The Legislature will closely monitor the rate of overhaul and repair at these nine armories, as well as the material conditions at all others, in order to ensure that readiness is not degraded in any part of the state.

Staff Recommendation: APPROVE the BCP.

VOTE: